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DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on the measures necessary to assure the continued solvency of the Airport and Airway Trust Fund (Trust Fund). Your invitation asked us to focus our testimony on the Trust Fund excise taxes, including their structure, the revenue raised from the taxes, the administrative problems with the taxes, and proposals to modify the domestic passenger ticket tax or substitute an alternative funding system. I will address these matters, but first I would like to bring to your attention a much more pressing issue.

As you know, when Congress extended the aviation excise taxes through December 31, 1996, it similarly extended our authority to transfer to the Trust Fund only those taxes that were actually received by the IRS by the end of 1996. Thus, we are not permitted to transfer to the Trust Fund taxes that are received in 1997, even if those taxes relate to air transportation that occurred in 1996.

This lack of extended authority is greatly exacerbated by the recent revelation that the airlines did not deposit until 1997 the vast majority of the taxes imposed in 1996. As a consequence, we have concluded that approximately \$1.2 billion transferred to the Trust Fund based on initial estimates should have remained in the General Fund and thus must be withdrawn. Given that the level of funding for the Trust Fund was already of serious concern, this adjustment to the Trust Fund forces us to focus immediately on ways to ensure the continued high standards for aviation safety. For the reasons I will discuss briefly below, the Administration urges an immediate extension of the Treasury Department's authority to transfer to the Trust Fund all of the revenues collected from these taxes, regardless of when they are received, together with an immediate reinstatement, through late September 1997, of the taxes dedicated to the Trust Fund.

The excess transfers to the Trust Fund occurred because the Treasury office responsible for authorizing transfers to the Trust Fund did not know that the airlines (relying on IRS advice)

were not making anticipated deposits.¹ Thus, our estimates, and our transfers to the Trust Fund, were much higher than actual deposits.

We have concluded that it is necessary to correct this error by transferring the \$1.2 billion excess back to the General Fund. But now that the actual tax payments by the airlines have been or are about to be made, we lack authority to transfer the monies from the General Fund to the Trust Fund.

Parenthetically, you may wonder why the airlines did not make full deposits in 1996 of taxes collected in that year. In large part it was because of reliance on the administrative procedure set up in the regulation governing deposits, which allowed payment under a safe harbor measured by the taxpayer's liabilities in the second previous quarter. IRS attorneys in the excise tax branch agreed with the airline industry's position that the regulation should be construed to permit current deposits based upon zero actual liability for the second previous quarter when the tax had lapsed. They were not aware of the inability to transfer post year-end receipts to the Trust Fund, since that was not an IRS function. Had top officials of the IRS and the Treasury been advised that the airlines were largely deferring payment of tax collections, we might have been able to alter that outcome, including, if necessary, by revising the deposit regulation quickly to require earlier deposit of much, but not all, of the 1996 tax liabilities.²

The second aspect of the problem is the urgency of extension of the lapsed taxes. Even with the renewal of authority to transfer after-collected taxes, some Federal aviation capital programs will, absent a reinstatement of these aviation excise taxes, run out of money in the near future. Such programs include the replacement of antiquated radar systems and airport grants. Although the ability to continue such programs will end in March 1997, or a few months later if the technical correction described above is made, earlier notices to contractors, in many cases almost immediately, will be necessary to avoid liability on projects where funds will run out without extension of the lapsed taxes. The FAA will be able to explain to you their exact financial situation.

¹Initial information regarding excise tax collections is available only in aggregate form. No information is available with respect to liability or collections for a particular excise tax source until quarterly returns are filed and completely processed by IRS, usually 6 to 9 months after a taxable quarter has closed. During October-November 1996, total excise tax collections, which were in excess of \$13 billion, were below forecast level by an amount that was well within the range of normal and acceptable forecasting error. It would appear that, in aggregate, deposits of all other excise taxes exceeded Treasury estimates, thus offsetting and masking the \$1.2 billion shortfall in Airport and Airway Trust Fund taxes.

²The Treasury Department intends to modify the regulatory safe-harbor provision on which the airlines relied to provide that when a new tax is imposed, or an expired tax is reinstated, taxpayers must deposit liabilities attributable to the new or reinstated tax on a current basis.

We therefore urge, in addition to the technical modification to the Treasury Department's authority to make transfers of aviation excise taxes to the Trust Fund, the immediate short-term reinstatement of those taxes through late September of this year, while the Administration works with Congress to devise a long-term solution.

Structure of Taxes

The Airport and Airway Trust Fund was created in 1970 to finance Federal aviation programs, including services provided by the FAA and grants for airport improvement. Since its creation, the Trust Fund has been supported, in large part, by Federal excise taxes on commercial air passenger and air freight transportation and on noncommercial aviation fuel. These taxes expired on December 31, 1995. The Small Business Job Protection Act of 1996 reinstated the taxes beginning on August 27, 1996, but the taxes expired again on December 31, 1996.

Before the expiration of these taxes at the end of last year, the tax on domestic air passenger transportation was 10 percent of the amount paid for the transportation, the tax on international air passenger departures was \$6 per person, and the tax on domestic air freight transportation was 6.25 percent of the amount paid for the transportation. The tax on noncommercial aviation fuel, to the extent dedicated to the Trust Fund, was 15 cents per gallon in the case of gasoline and 17.5 cents per gallon in the case of fuel other than gasoline.³

Revenues from Taxes

The table below shows total liabilities and the composition of those liabilities for the taxes that fund the Airport and Airway Trust Fund for FY 1993 through FY 1996.⁴ The table shows that liabilities from the aviation excise taxes increased from \$4.9 billion in FY 1993 to \$5.7 billion in FY 1995, and then decreased to \$1.8 billion in FY 1996. The reduction in liabilities reflects the lapse in the aviation excise taxes from January 1, 1996 through August 26, 1996.

The table also shows that the tax on domestic air transportation accounts for most of the liabilities from the aviation excise taxes (87.5 percent). The other aviation excise taxes account for 12.5 percent of total liabilities, as follows: the tax on domestic air freight transportation (5.8

³The Omnibus Budget Reconciliation Act of 1993 imposed an additional tax of 4.3 cents per gallon on both commercial and noncommercial aviation fuel. Revenues from this tax, which remains in effect and is not scheduled to expire, are retained in the General Fund.

⁴Liabilities incurred for a given year may differ from net receipts to the Trust Fund, due to adjustments made during that year which relate to prior periods.

percent), international air passenger departures (4.5 percent), aviation fuels other than gasoline (2.0 percent), and gasoline (0.2 percent).⁵

Liabilities from excise taxes that finance the Airport and Airways Trust Fund: FY 1993-1996 (\$ millions)				
	FY 1993	FY 1994	FY 1995	FY 1996
Domestic air transportation	4,316	4,747	4,928	1,557
Domestic air freight	238	330	335	126
International air passenger departures	224	225	256	87
Aviation fuels (other than gasoline) ⁶	101	118	139	5
Gasoline ⁷	6	21	8	1
Total	4,885	5,441	5,666	1,776

Administrative Problems with Taxes

The IRS has identified various administrative problems with the current tax. Some of these problems are attributable to the fact that the taxes on air transportation are imposed on the person purchasing the transportation rather than the transportation provider. Although the transportation provider is required to collect the tax and remit the amounts collected to the Treasury, the IRS may have no effective remedy when the transportation provider does not collect and remit the tax. In those cases, the IRS must either establish that the transportation provider's failure was willful or attempt to collect a small amount of tax from each of the persons to whom transportation was provided. Additional difficulties arise when the tax expires or is reinstated. For example, the expiration of the tax at the end of 1995 resulted in numerous small refund claims from individual passengers who purchased tickets in 1995 for travel during 1996.

⁵Net receipts from the additional 4.3-cents-per-gallon tax on commercial and noncommercial aviation fuels were \$28 million in FY 1993, \$38 million in FY 1994, \$41 million in FY 1995, and \$568 million in FY 1996. Deposits received relating to these taxes remain in the General Fund. The application of the 4.3-cents-per-gallon rate to fuel used in commercial aviation began in FY 1996.

^{6/7}These liabilities are net of refunds for exempt uses and certain adjustments.

The differing tax treatment of commercial and noncommercial aviation is also a source of difficulty. When the same aircraft is used to transport passengers or property for hire and to transport employees or property of the owner (or the affiliated group to which the owner belongs), the tax that applies is determined on a flight-by-flight basis. In the case of flights that transport passengers or property for hire, tax is imposed on the amount paid for the transportation, but the fuel used is exempt from tax (other than the 4.3 cent general fund tax). Dual-use aircraft, however, are likely to use fuel that has already been taxed at the full rate, necessitating a claim for refund. In addition to the administrative burden of filing and processing refund claims, the rules relating to dual-use aircraft can result in inappropriate revenue losses because a flight is treated as commercial aviation (and not subject to the Trust Fund fuel tax) if it carries a single fare-paying passenger. In other words, a substantial fuel tax can be avoided by paying a relatively small tax on a single passenger's fare.

The administrative problems discussed above do not result in significant revenue losses. We would, nevertheless, be pleased to work with Congress to develop legislation that would address the IRS concerns.

We also note that the air transportation taxes may lead to allocation disputes. This occurs because express delivery services generally involve a combination of air transportation and ground services. In such cases, only the amount paid for the air transportation is subject to tax, and it is therefore necessary to determine the extent to which the total amount paid is allocable to air transportation. The IRS believes that some taxpayers are taking advantage of these rules by allocating an inflated amount to ground services to avoid the tax. This problem is inherent in a tax imposed on amounts paid for taxable services that are commonly bundled with other services. The IRS believes, however, that its concerns can be minimized by appropriate changes to its regulations and is currently studying this issue.

Proposals to Modify Taxes or Substitute an Alternative Funding System

The Administration is also represented at this hearing by Louise Frankel Stoll of the Department of Transportation. Her testimony will discuss in greater detail the allocation and funding issues as they affect the FAA's programs and operations. As you know, Congress has directed further study of the issues relating to FAA financing. The Federal Aviation Reauthorization Act of 1996 (P.L. 104-264) requires an assessment by an independent contractor of FAA's funding needs and the costs imposed by each segment of the aviation industry on the airport and airway system. This assessment, which is due later this month, should provide a useful starting point for efforts to develop a secure funding source for Federal aviation programs. The Reauthorization Act also creates a National Civil Aviation Review Commission to study how best to finance the FAA in light of this assessment of funding needs and system costs. The Commission is scheduled to report its findings and conclusions to the Secretary of Transportation by August 1997. In addition, by October 1997, the Secretary of Transportation, after consultation with the Treasury Department, is required to provide Congress with the

Administration's recommendations for funding the needs of the aviation system through 2002.

We believe it would be inappropriate to propose a specific system of new fees or taxes without the benefit of the Commission's recommendations. The Administration will, of course, be pleased to work with this Committee to develop a long-term financing solution when the study is complete and the Secretary of Transportation has reported his recommendations to Congress.

Mr. Chairman, this concludes my written testimony. I will be pleased to answer any questions you or other members of the Committee may have.